DOW THEORY LETTERS INC.

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THE RETURN OF THE "MAGIC 5%": The accompanying news clip reflects the slaughter in last Wednesday's (June 14) Treasury Bond market. It was an historic session, and that is why I have placed this paragraph at the beginning of the Letter. On Wednesday, for the first time since the tight money crisis of late-1966, 5% yields returned to the U.S. Treasury list (brackets on chart). I call it the beginning of the 1967 tight money cycle. And this could be the start of the biggest financial story of the year (more on this later in the Letter).

Treasury Bonds

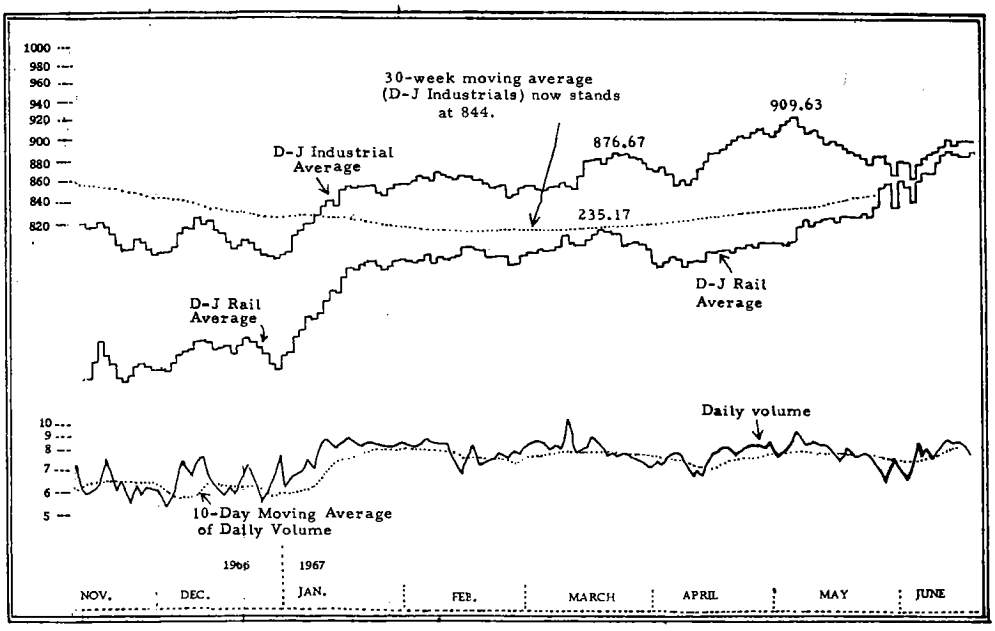
NEW YORK (AP) — Closing over the counter U.S. Treasury bonds, bid, asked, net change and yield for Wednesday.

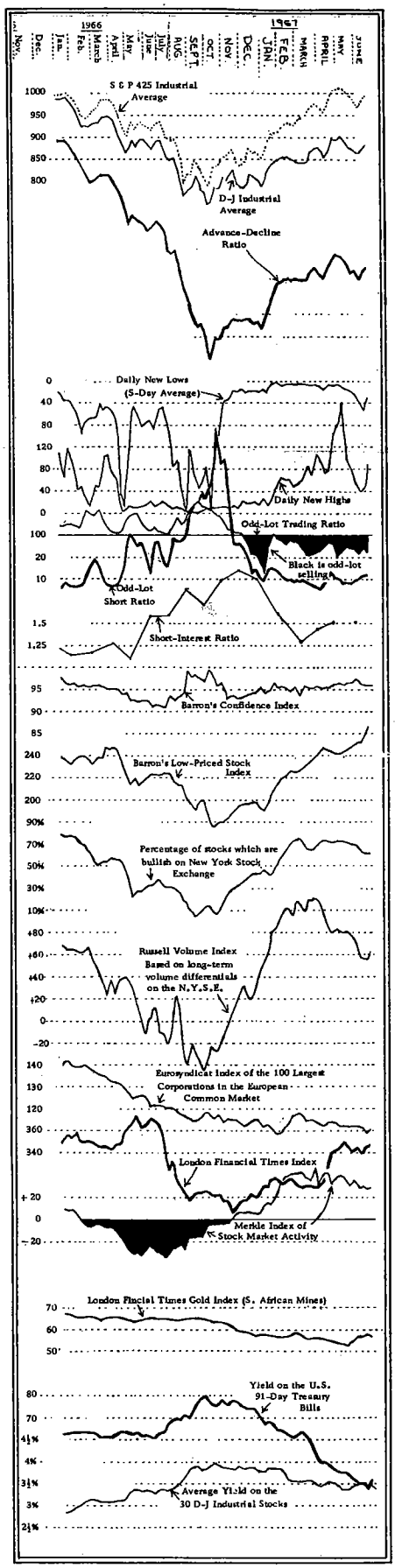
3⅜s	67	99.47	99.29	—.1	3.84
3⅞s	68	99.18	99.22	—.2	4.22
3¾s	68	99	99.4	—.4	4.53
3⅞s	68 Nov	99	99.4	—.4	4.52
2½s	68-63	97.8	97.12	—.2	4.33
4s	69 Feb	98.24	98.28	—.8	4.71
2½s	69-64 Jun	96.2	96.6	—.4	4.51
4s	69 Oct	98.4	98.8	—.6	4.81
2½s	69-64 Dec	95.4	95.8	—.4	4.53
4s	70 Feb	97.22	97.26	—.6	4.91
2½s	70-65	94.18	94.26	—.6	4.52
4s	70 Aug	97.10	97.14	—.6	4.88
2½s	71-66	93	93.8	—.6	4.50
4s	71	96.20	96.29	—.8	4.85
3⅞s	71	95.24	96	—.8	4.90
4s	72 Feb	95.28	96.4	—.10	4.95
2½s	72-67 Jun	90.8	90.16	—.12	4.65
4s	72 Aug	95.16	95.24	—.12	4.94
2½s	72-67 Sep	89.28	90.4	—.12	4.64
2½s	72-67 Dec	89.16	89.24	—.12	4.63
4s	73	94.12	94.20	—.14	5.02
4⅛s	73	95	95.8	—.14	5.00
4½s	74	94.30	95.6	—.16	4.98
4¼s	74	95.18	95.26	—.16	4.97
3⅞s	74	93.8	93.16	—.16	4.93
4s	80	90.20	91.4	—.4	4.94
3½s	80	85.12	85.28	—.4	4.95
3¼s	83-78	80.28	81.12	—.4	4.93
3¼s	85	80.24	81.8	—.4	4.82
4¼s	85-75	91.28	92.12	—.4	4.91
3½s	90	81.4	81.20	—.8	4.84
4¼s	92-87	89.28	90.12	—.8	4.91
4s	93-88	87.8	87.24	—.4	4.83
4¼s	94-89	87.28	88.12	—.8	4.91
3s	95	80.8	80.24	—.8	4.16
3½s	98	81.4	81.20	—.8	4.61

Prices quoted in dollars and thirty seconds.

THE MARKET: The remarkable crisis in the Middle-East has come and to a large extent has passed. The Vietnam war goes on. The U.S. moves into the time when it must face one of the largest budget deficits in its history. The monetary and gold picture remain clouded. The private sector of the economy continues sluggish. The war sector steams ahead full blast, providing the main prop under an inflated and shaky economy.

Meanwhile, an intensely speculative bear market rally has spread a layer of froth over Wall Street, masking the true underlying picture. And that picture is one of discrepancies divergences, dangerous undertones. Since the 1966 lows the blue-chip D-J Industrial Average has staged a two-thirds recovery, the speculative Rail Average has recovered 83% of its 1966 losses. The S & P 425 Industrial Average has pushed to a new high (as has the broad S & P "500"), then faltered to build a potential "double top." Currently, the D-J 65 Stock Average does not look too different from the DJI, having stalled well under its 1966 high. The rally in Utilities since the 1966 lows has been sluggish and sub-standard. The Utility Average recorded its high in April, 1967, then moved steadily lower. Last week saw Utilities break to a new 1967 low, and this was followed by a new 1967 low on the D-J 40-Bond Index. Surveying the whole scene, I call it a mixed picture with quality securities acting sluggishly while the speculative sectors make new highs.




S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline Ratio
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index Based on long-term volume differentials on the N.Y.S.E.
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fincial Times Gold Index (S. African Mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

All in all, I see nothing in 1967's market action to make me believe that we are witnessing anything but a major correction of the 1966 bear market decline. I realize that few of today's market students have ever seen a major bear market correction of the stature of a 1906, a 1930 or a 1938. In my opinion, we are seeing one now, and it is every bit as frothy, explosive and deceptive as the major bear rallies of yesteryear.

WHAT OTHERS ARE SAYING: From Argus Research, one of Wall Streets leading independent investment advisors. "Whether private spending is restricted by tight money — as last year — or by higher taxes, the results cannot be very different. In either case, most industries primarily devoted to civilian production are faced with a profit squeeze. With wage rates rising by five, six and even seven percent a year, and with sales volume held down by increased taxes, productivity gains sufficient to offset higher costs are out of reach for most companies. At the same time, growing overcapacity in many industries offers little prospect of relief through higher prices."

From the June Economic Letter, First National City Bank (N.Y.C.): "Expectations of an early rebound in the economy have been disappointed. Sluggishness has persisted in April and early May. Moreover, revised first quarter figures now show the economy grew only in terms of prices. The real gross national product declined slightly, ending nearly six years of continuous expansion."

The Dines Letter (June 16): "In sum, we would continue to maintain a constructive attitude towards the stock market, consisting of cautious optimism."

The Drew Odd Lot Studies (June 17): "Despite the obvious fundamental uncertainties, the fact remains that the market has been demonstrating a remarkable degree of technical strength. It would appear that a new phase of intermediate uptrend was initiated from the recent low and in the normal course of events, this should carry well above the early May high in due time."

The Granville Market Letter (June 16): "Airlines as a group have in the past shown bellwether characteristics for the general market. With little fanfare the group has been quietly going into a nosedive since March, and despite the general market turnabout from the June 5 lows, the situation has steadily worsened."

From Money & Credit Reports by Irving Weiss (June 16): "Now, watch for the promissory note stage of the money crisis. This is the stage where business finds it cannot raise the money from banks and other financial sources, nor can it raise it in the bond market on a long term basis, so it resorts to the short term market and writes promissory notes bearing high rates of interest to attract cash."

From Schaefer's "Dow Theory Trader" (June 17, 1967): "Selective, speculative issues are running wild, and should continue to do so for a short while longer. As I see it, this is the way that this particular rally since the October 8, 1966 low is going to top out, and it is going to take more time. Stocks are beingdistributed to the public in a manner which is much bigger and more dangerous than in 1929, and once this distribution is finished, the market should fall out of bed, and it should be at least two decades before prices get up to present levels again."

From the London Economist (June 17): "The latest survey of businessmen's plans to buy new plant and equipment confirm what everyone knew already — that the slackening of the American economy in the first quarter of this year had been greater than forecast. Capital outlays had been expected to fall slightly but they actually fell at an annual rate of over $1 billion, when allowance is made for seasonal factors, the largest drop since the 1960 recession."

From the Janeway Service (June 14): "Meanwhile, the Administration is just as anxious as the private participants in the guessing game about the extent of the autumn upturn: the less vigorous it is, the bigger the deficit is going to be because, thanks to the war, expenditures are going to continue up; and, thanks to the war's unpopularity, expenditures unrelated to it are going to go up too. The only variable is on the revenue side of the Treasury's income account, which swings with earnings.

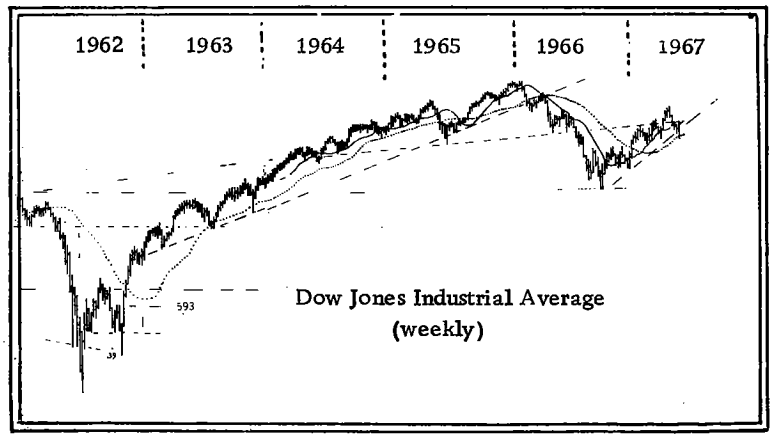
Why such an important correction now? The 1930 retracement was a direct result of the unbelievable downside compression of the 1929 crash. Violent action in the market breeds equally violent counter-reactions. But today's market is different. The 1966 sell-off was not comparable in severity to 1929. But the war in Vietnam has provided the false hopes behind the 1967 recovery. The fact is that without the war our economy would now be in recession. Many important sectors of the non-military picture are now sluggish or in trouble, and this includes autos, steel, home-building, textiles, television, appliances, auto supplies. Despite slipping corporate profits, high inventories, and rising interest rates the war in Vietnam has served to kindle the spirits of the speculators. And thus we have a high-riding speculative recovery serving to mask a situation which comprises more problems and more severe problems than was the case during 1966.

I find it interesting to note that all but a very few analysts and stock market services have now turned bullish. Yet I see nothing particularly unusual in that. Competition in this field is tougher than ever, and each issue of Barron's announces the arrival of one or two new investment services, each featuring "new" investment devices. The majority of these new entries are going to find the going difficult; they will find themselves in the position of having to appeal to the public and more specifically the greediest and most sensation-seeking sector of the public. I have seen too many services caught too many times on the wrong side of the primary trend. In 1957-58, for instance, when bearishness was rampant, I felt I was arguing with almost every analyst in the business (with one or two exceptions, of course). It doesn't bother me in the least to be on the wrong side of the forecasting consensus. In fact, I feel more comfortable arguing with the majority of the "investment fraternity."

For over a month (since May 8) the Industrials and Rails have built a most extraordinary series of divergences or "out-of-gear" movements. Again and again the Rails have risen to new bear market rally highs, but since May 8 not one of these recovery highs has been confirmed by Industrials. Furthermore, while the speculative Barron's Low-Priced Stock Index has confirmed by rising to new historic highs, the quality Utility and 40-Bond Averages have dropped to 1967 lows. On the face of it, the better quality the index the poorer the showing; the more speculative the index the better the showing. It should be remembered that for the better part of 17 years the 1949-66 bull market was led upward by such blue-chip stalwarts as duPont, General Motors, General Electric and Union Carbide. This has hardly been the situation during the 1966-67 bear market recovery. This was a case of the bubbles lifting the solid values. But bubbles are short-lived, and when they rise too high they "pop." That is what I expect will happen to the speculative sector of the market during the year ahead.

Few investors realize that the 1964 high for the D-J Industrial Average was 891.71, recorded on November 18. The 1965 peak for the Industrial Average was 939.62, recorded on May 14. The 1966 peak was 995.15, touched on February 9. Thus, it may come as a surprise to most to realize that the Dow is currently under the peak prices of the years 1964, 1965 and 1966. In effect, the Industrials have (on average) gone nowhere in three years.

In case anyone doubts this, I have included the long-term chart (D-J weekly high-low range) from Quote Digest (110 N. Lorraine, Wichita, Kansas). On this chart it becomes fairly obvious that the upside momentum of the Dow ran out around 1964. Following 1964 the Industrials pushed up to a 1965 peak, broke sharply, rallied to a 1966 all-time high, caved in during the 1966 bear market sell off, then pushed up to form the bear market recovery pattern of 1966-67. As of this writing, the recovery has failed to surpass the peaks of the past three years. I call it distribution. But few people study the big picture.

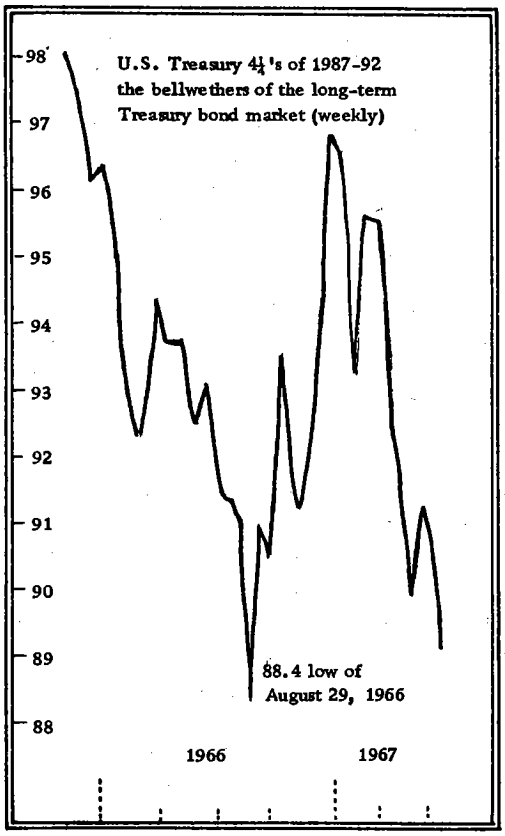


THE MOVING FINGER: If you are addicted to financial "adventure stories," perhaps the greatest such story of the past few decades is now shaping up in the money markets. This story is so important that I insist that my readers direct their attention here. The smartest money in Wall Street is watching this story. Every investor owes it to himself to watch it too.

In the publication, "The Bond Buyer," which is perhaps the bible of the money market, an article was published last week entitled "Uncertainties Make Budget A Shambles." The sub-title ran, "What was a U.S. budget document only five months ago has now been made a shambles by the uncertainties over Vietnam and the economic outlook." The fact is that the U.S. budget is running wild, and every money man in the nation is scrutinizing the figures wondering how the situation is going to be solved (if indeed it is to be "solved").

Here are some of the facts. If Congress fails to enact a 6% surtax the U.S. will lose $4.7 billions of revenue. The House Appropriations Committee may be $4.5 billions short on its estimates of war costs. The reactivation of the 7% investment credit could cost the U.S. $2.5 billions in revenue. If Congress fails to allow the U.S. to sell Certificates of Participation, the cost will be upwards of $5 billions. These items alone could push the total coming U.S. deficit above $24 billions. But further probable war costs are almost sure to produce a budget deficit nearer $29 billions—or even beyond. The fact is that no one really knows.

Here are some of the questions the "Bond Buyer" asks. (1) How big will Government spending be in 1968? (2) How big will the deficit be? (3) How will the deficit be financed? (4) How big will the new tax increase be, and how much will it brake business? (5) How much direct new financing can the money market absorb without touching off another major credit squeeze? (6) When is "positive, affirmative action in new fiscal steps to be taken by Congress or the Administration?" (7) "And finally—who is in charge here?"



I include a weekly chart of the 4 1/4 Treasury bonds of 1987-92, the issue which is held to be the bellwether of the long-term Treasury bond market. The price of this bond may be likened to the path of the D-J Industrial Average in the stock market.

Note the collapse of the bond during the 1966 money crisis, and the final 88.4 (bonds are quoted in 32nds of a dollar so this is 88 and 4/32's) low of August 29, 1966. Then came the rally of 1966-67 which took the bond up to 97. Since the February, 1967 high, the 4 1/4's have plunged sharply to a 1967 low of 89.23 (May 23). A little rally ensued, and last week (on June 14) the 4 1/4's broke to a new 1967 low of 89.16 to yield 4.95%.

Last week's low put the 4 1/4's little more than a point above the 1966 "crisis low," and it was here that the Treasury began to "run scared." Here is why they are scared. Last week, of 37 listed Treasury bonds, 17 were yielding above 4.9%, 7 above

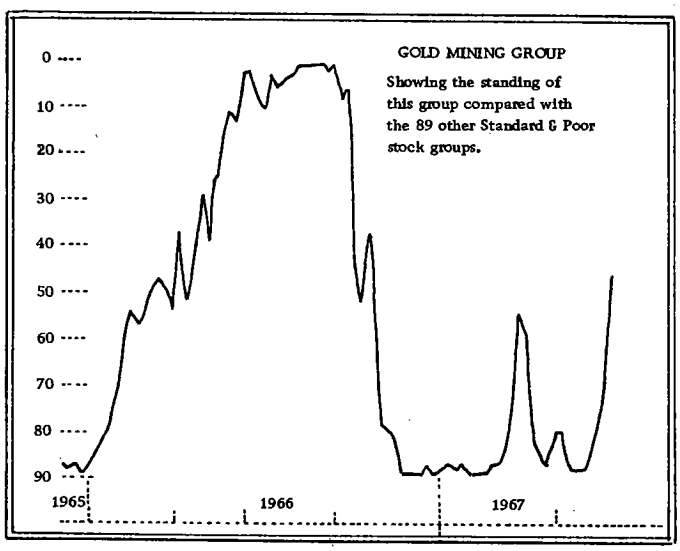
5%. At those yields, institutions would rather buy Treasury bonds than mortgages, and the effect (among other things) is to shut off mortgage money again, much as was the case in 1966.

According to the June 14 Wall Street Journal, "Industry officials are backing away in droves from their earlier predictions that the second half would bring a surge in new construction starts. Some builders now worry that 1967 homebuilding may turn out to be even sicker than last year, which was the worst since 1957." What to do? The Federal Reserve has attempted to prop up the long-term Treasury bonds market, purchasing selected issues to raise prices (thereby lowering yields). Against Federal Reserve manipulations we have the forces of the marketplace, trying to appraise what will happen when the 1968 budget deficit is up for financing. Can the New Economists hold up the money market? There is not a man alive who knows for sure.

But if the Treasury fails, my chart will show it. My "panic level" is the 88.4 low of 1966 registered by the 4 1/4's. If the bond breaks below the 1966 low my guess would be that the money markets will turn chaotic again. This will constitute a major "bear signal" in the bond market, a signal every bond buyer will recognize. To put it another way, it would be comparable to General Motors and duPont breaking to a new low for the year on the N.Y.S.E. But in many ways, a new low for the 4 1/4's would be more fundamental and more significant. It would shake bond buyers, mortgage buyers and financial institutions across the country. It would shut off the faucets of business.

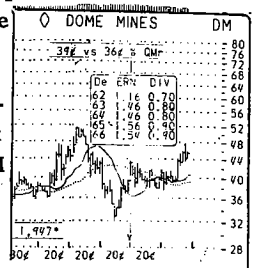
So there it is, one of the biggest "if's" on the financial scene— all compressed in one "technical nutshell" by way of a chart of the 4 1/4's of 1987-92. I'm not going to predict the outcome, but I will say that I am not hopeful. It's my own personal opinion that what is coming up is too big, too powerful, to be handled by the manipulations of the Federal Reserve. We should know in the next few months or so.

LATE COMMENTS: Many factors have been holding this primary bear market up, preventing the major downward forces from expressing themselves as they normally do in a bear market. Vietnam, the Mid-East, Government manipulation of the economy and the money markets, all this has been holding back the bear. Nevertheless, I believe we can count on the bear pressures ultimately to prevail. And when they do, following this long period of manipulation, I feel the situation will be more severe than it would have been had the trouble occurred earlier.



Money is growing tighter, corporate profits are being squeezed, the international picture is getting more complicated, and in the face of this, speculation has been rampant on all the exchanges. As an added comment regarding the "rotten foundations" which lurk under this bear market rally, I have included a chart which I keep, based on the group momentum of the S & P Gold Group (statistics from Chartcraft, Larchmond, N.Y.). This type of analysis has been quite reliable in the past, and you will notice how the chart broke just ahead of the gold stock drop of late-1966. Since then the chart has been showing increasing strength in the Gold Group. Last week the indicator jumped to 46, highest figure since October, 1966. This could well be the prelude to a move in golds— and if so, trouble in the market.

In the last Letter I inadvertently included a wrong chart, a chart which should have been Dome Mines. I recommend Dome for purchase, and its large position in Dome Petroleum is, of course, an added "kicker." The stock acts well, and I feel that it should be held for the next few years, in preparation for a major rise. (Chart of DM courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas).



QUOTE OF THE WEEK: From the June issue of Esquire, "From the U.S.A. to All the World, With Love," an article by Senator Frank Church: " In the eyes of much of the world, the United States is more intent on furnishing swords than plowshares. During the past seventeen years, we have bestowed on foreign governments $8,000,000,000 in military vehicles and weapons, $7,000,000,000 in aircraft, $5,000,000,000 in ammunition, $2,000,000,000 in ships, $2,000,000,000 in communications equipment, $1,500,000,000 in missles and $3,000,000,000 in other supplies. Services granted in the form of base construction, training, repair, and spare parts amounted to an additional $8,000,000,000, for a staggering total of $36,500,000,000 dispensed abroad since 1950."

NOTICE: I will have an important and exciting announcement in the new issue of Dow Theory Letters. I believe that all subscribers are going to be interested— and pleased.